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DEFENSE CONTINUES TO SUBSIDIZE SALES OF SECONDARY ITEMS TO FORE--ETC(U)
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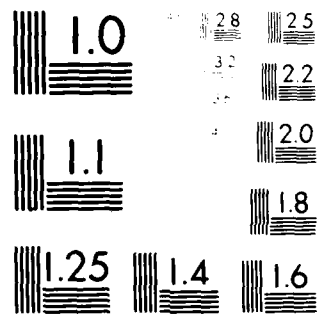
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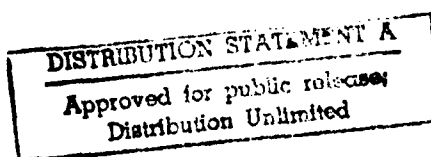
Comptroller General

OF THE UNITED STATES

Defense Continues To Subsidize Sales Of Secondary Items To Foreign Governments Because Of Poor Pricing Policies

Over the years, the Congress has made it clear that Defense appropriations are not to be used to subsidize the foreign sales program. However, according to GAO estimates, over \$8 million of Defense appropriations were used to subsidize the foreign military sales program in fiscal 1979 at four inventory control points because of inadequacies in estimating replacement costs of secondary items sold from inventory. GAO believes that additional millions of dollars in subsidies occurred because all foreign governments were not billed for certain indirect costs associated with these sales.

GAO is recommending actions, including legislative changes, necessary to improve Defense's pricing policies and procedures for sales of secondary items.



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COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

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B-204400

The Honorable Charles H. Percy
United States Senate

The Honorable Ernest F. Hollings
United States Senate

Your letter of May 27, 1980, expressed concern that prior General Accounting Office recommendations to improve the accounting and financial management of the foreign military sales program had not been implemented by the Department of Defense. You asked that we evaluate recent Defense actions to improve its financial management of the program and to reduce its budget by eliminating subsidies to the foreign military sales program.

This report focuses on the actions taken by Defense to revise and implement the policies, procedures, and accounting systems used to price sales of secondary items to foreign customers. Specifically, the report discusses whether prices billed foreign customers for secondary items are adequate to replace the items in Defense inventories and thus avoid Defense subsidization of the foreign military sales program.

At your request, we did not obtain official agency comments on the matters discussed in this report.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this report until 7 days from the date of the report. At that time, we will send copies to interested parties and make copies available to others upon request.

Milton F. Aroian

Acting Comptroller General
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REPORT BY THE
COMPTROLLER GENERAL
OF THE UNITED STATES

DEFENSE CONTINUES TO SUBSIDIZE
SALES OF SECONDARY ITEMS
TO FOREIGN GOVERNMENTS
BECAUSE OF POOR PRICING POLICIES

D I G E S T

Defense continues to make large subsidies to the foreign military sales program because prices charged for secondary items 1/ sold from Defense inventories are not sufficient to replace the items. Although GAO reported this situation 3 years ago, Defense has not taken adequate corrective actions.

Subsidies are also occurring because foreign customers are not charged an equitable share of normal inventory losses, as GAO stated in three earlier reports.

The Arms Export Control Act of 1976 requires that if items sold from inventory by the Department of Defense are intended to be replaced, the prices charged to foreign customers must cover replacement costs of those items.

At the request of Senators Percy and Hollings, GAO followed up on its previous reports to determine if Defense was still subsidizing the foreign military sales program.

REPLACEMENT COST NOT RECOVERED

Based on a random sample of fiscal 1979 sales of secondary items to foreign governments, GAO estimates that the foreign military sales program was subsidized through Defense appropriations by over \$8 million at the four inventory control points visited. Underbillings occurred primarily because (1) compound inflation factors were not applied and (2) the rate of inflation used to estimate replacement cost was unrealistically low.

1/Secondary items are usually reparable and nonexpendable spare and repair parts bought with the military services' direct appropriations.

A similar study conducted by Defense personnel confirmed that billing prices were not adequate to cover replacement costs.

Inflation factors should be compounded

Many secondary items are procured infrequently; consequently the price at which items are carried in inventory may reflect a cost incurred 1 or more years before. GAO had previously recommended that, to adequately recover replacement cost when selling these items, the sales price should include compounded inflation factors from the time the items were last purchased to the selling date. Defense procedures, however, require only a single year's inflation rate to be added to the inventory price to recover estimated replacement cost. (See p. 8.)

For example, the Army purchased frequency converters in August 1977 at a unit price of \$3,314. In February 1979, the Army sold two of the items to foreign customers for \$3,539 each (\$3,314 plus a single year's inflation rate: the fiscal 1979 inflation factor of 6.8 percent). Eight months later the replacement price of the item was \$6,899. Thus the Army underbilled by \$3,360 per item. Although using compounded inflation factors as GAO recommended would not have covered the full replacement cost in this instance, it would have more closely approximated the replacement cost and reduced the amount of loss on the sale.

Defense inflation rate estimates are too low

GAO found that the inflation rates prescribed to the military services for estimating replacement prices are much too low. The rates Defense prescribed are based on those provided by the Office of Management and Budget for preparation of the President's budget. Historically, these rates have been shown to be a conservative forecast of price changes. A Department of Defense official told GAO that these official rates have proved to be too conservative in 10 of the last 11 years. (See p. 9.)

A recent Air Force Logistics Command study of contracts for 150 secondary items showed an average cost increase of 23 percent in fiscal 1980. These items were budgeted at an inflation

rate of 7 percent. Also, the Pratt and Whitney Aircraft Company, a major supplier of secondary items for the Air Force, recently advised the Air Force Logistics Command that secondary item prices in fiscal 1981 would be 25 to 30 percent higher than in fiscal 1980. The current procurement account inflation rate for fiscal 1981 is 9.7 percent.

ALL NORMAL INVENTORY LOSSES
ARE NOT REQUIRED TO BE RECOVERED

Additional subsidies to the foreign sales program occurred because some foreign customers who purchased secondary items from Defense inventories were not charged enough to cover normal inventory losses. For the four locations visited, GAO estimates that this subsidy amounts to about \$3.3 million each year.

In passing the Arms Export Control Act, the Congress intended that all indirect and direct costs be recovered so that the foreign military sales program would not be subsidized by Defense appropriations. Normal inventory losses--those caused by obsolescence, damage and deterioration, and pilferage--are indirect costs. However, the act, as amended in 1978, requires only that foreign governments be charged for normal inventory losses on sales from stock that is being stored at the expense of the purchaser.

Because participation in Defense inventories was believed to be limited to selected customers, the requirement for recovering normal inventory losses was not extended to all sales from inventory. Only certain foreign governments with long term contracts to purchase supply support from Defense bear the expenses of inventory storage. The reason for this is the theory that the other customers do not participate in or benefit from the Defense logistics system.

GAO found, however, that foreign governments who had not established long term contracts for supply support were participating in and benefiting from the Defense logistics system. All foreign governments have received benefits from the Defense inventory system. Accordingly, all should have paid an equitable portion of normal inventory losses. Allocating indirect costs such as inventory losses to all customers benefiting from the system that generated those costs is a standard accounting practice. (See pp. 10-12.)

SPECIAL DEFENSE UNIT
IS BEING ESTABLISHED
TO MONITOR PRICING PRACTICES

Over the past 6 years GAO has issued more than 30 reports that together cite hundreds of millions of dollars in unrecovered costs due to inadequate pricing policies and practices. Three years ago, GAO recommended that a special unit be created to ensure the adequacy of foreign military sales pricing (FGMSD-78-51). After some delay, the Department of Defense has recently established a quality assurance unit at the Security Assistance Accounting Center to monitor foreign sales pricing. With proper guidance and effective implementation, this unit should more adequately detect and resolve the type of pricing problems described in this report. (See p. 13.)

OPPORTUNITY EXISTS
TO RECOVER UNDERBILLINGS

The standard Defense foreign military sales contract provides that adjustments may be made to estimated costs that are not commensurate with actual costs up to and including final billing. Therefore, any costs that have not been recovered by the military services on those sales contracts for which final billing has not been made could and should be billed. As to undercharges that may be found after final billing, the Defense instruction provides that adjustments to final billings are permitted when there are unauthorized deviations from Defense pricing policies.

The longer the Defense Department takes to attempt to collect undercharges, the more difficult it will be to recover these amounts from foreign governments. Therefore, collection attempts should be initiated as soon as undercharges are discovered; if possible, this should be before the military services make final billings for contracts on which the undercharges occurred. (See p. 13.)

RECOMMENDATION TO THE CONGRESS

To ensure that all foreign governments are treated equitably and all indirect costs are charged, GAO recommends that the Congress amend the Arms Export Control Act to require that all sales from Defense inventories reflect the cost of normal inventory losses. (See p. 14.) (Suggested legislative language is in app. III.)

RECOMMENDATIONS TO THE
SECRETARY OF DEFENSE

To help ensure equitable and effective pricing of secondary items and avoid subsidies to foreign customers, GAO recommends that the Secretary of Defense:

- Instruct Defense components to use compound inflation factors when estimating replacement cost. (See p. 14.)
- Prescribe a more realistic inflation index. (See p. 14.)
- Use the quality assurance unit recently established at the Security Assistance Accounting Center to ensure that Defense components adequately and uniformly implement the revised estimation procedures. (See p. 14.)
- Direct the military services to make every reasonable effort to recover from foreign governments the past undercharges in sales of secondary items. (See p. 14.)

AGENCY COMMENTS

As requested by the Offices of the Senators requesting this review, GAO did not obtain official comments from the Department of Defense.

C o n t e n t s

		<u>Page</u>
DIGEST		i
CHAPTER		
1	INTRODUCTION	1
	Secondary item sales	2
	Authority for foreign military sales	2
	Recommendations in prior GAO reports	3
	Inadequate method is used to estimate replacement costs	3
	Foreign customers do not share normal inventory losses	3
	Objectives, scope, and methodology	4
2	ITEMS ARE SOLD TO FOREIGN CUSTOMERS AT LESS THAN REPLACEMENT COST	7
	Replacement costs are not recovered	7
	Inflation rates should be compounded	8
	More realistic inflation factors are needed	9
	All normal inventory losses are not required to be recovered	10
	Establishment of quality assurance pricing program has been initiated	13
	Opportunity exists to recover underbillings	13
	Conclusions	13
	Recommendation to the Congress	14
	Recommendations to the Secretary of Defense	14
APPENDIX		
I	May 27, 1980, letter from Senators Charles H. Percy and Ernest F. Hollings	15
II	Air Force Institute of Technology study dated June 19, 1981	16
III	Suggested amendment to the Arms Export Control Act	18

CHAPTER 1

INTRODUCTION

By letter dated May 27, 1980 (app. I), Senators Percy and Hollings expressed concern that prior General Accounting Office recommendations to improve accounting and financial management of the foreign military sales program had not been implemented by the Department of Defense. They requested that we evaluate recent actions taken by Defense to improve its management of the program. Our previous reports had indicated potential budget reductions through eliminating subsidies to the foreign military sales program.

In accordance with the Senators' request, we have made a followup review of the policies and procedures Defense used to price secondary items sold to foreign customers under other than cooperative logistics supply support arrangements. These arrangements are agreements between the United States and foreign governments which permit the foreign governments to invest in and participate as a partner in the Defense logistics system. The foreign governments are required to put up advance equity funds equal to a stated portion of the inventory items to be purchased. Once the arrangement has been negotiated, Defense components may increase their inventory levels in anticipation of the foreign customers' requisitions. Since in effect these sales are prepaid, the customers are charged inventory prices, 1/ which may be substantially less than current replacement costs.

In August 1978, we reported 2/ that Defense pricing policies for sales of secondary items were inadequate to recover replacement cost because the impact of inflation was not properly considered. Two additional reports, in September 1977, 3/ and May 1979, 4/ disclosed that foreign customers were not being assessed a fair share of normal inventory losses. As a result of these practices, the Department of Defense did not charge, as required by law, for millions of dollars of incurred costs for items sold in the foreign military sales cases we selected for review. In effect, Defense appropriations subsidized the program.

1/The inventory price is usually the cost of the most recent representative procurement plus a charge to cover transportation from the manufacturer to the initial storage facility.

2/"The Department of Defense Continues to Improperly Subsidize Foreign Military Sales," FGMSD-78-51, Aug. 25, 1978.

3/U.S. General Accounting Office report to the Secretary of Defense, FGMSD-77-4 . Sept 3, 1977.

4/"The Defense Department Continues to Subsidize the Foreign Military Sales Program by Not Charging for Normal Inventory Losses," FGMSD-79-31, May 15, 1979.

This report focuses on the actions taken by Defense in revising and implementing the policies, procedures, and accounting systems it used to price sales of secondary items to foreign customers. Specifically, the report discusses whether prices billed foreign customers for secondary items are adequate to replace the items in Defense inventories and thus to avoid Defense subsidization of the foreign military sales program.

SECONDARY ITEM SALES

Secondary items are those items budgeted and programmed under the line item for spare and repair parts in a military service's procurement appropriation. These items are bought with the service's direct appropriations and are furnished to its operating organizations without reimbursement. Secondary equipment items and spare parts are repairable, nonexpendable items, such as test benches, manifolds, actuators, and generators.

Secondary item sales are made under several types of agreements. In addition to cooperative logistics supply support arrangements, sales are made under such support arrangements as blanket, open-end sales agreements which do not require the foreign government to provide an equity investment.

The dollar value of secondary items sold from inventory to customers other than those with cooperative arrangements is significant. The Department of Defense estimated total fiscal 1979 sales at \$84 million; Army at \$45 million; Navy at \$9 million; and Air Force at \$30 million. The four inventory control points included in our review had sales estimated at about \$68 million (or 81 percent of total sales) in fiscal 1979. As sales of major weapons systems continue, sales of secondary items can be expected to grow appreciably. It is widely recognized by Defense officials that costs of follow-on support, including spare parts, can eventually exceed a weapons system's initial cost.

AUTHORITY FOR FOREIGN MILITARY SALES

Foreign military sales are transacted under the authority of the Arms Export Control Act of 1976. The legislative history of the act indicates congressional intention that all costs, both direct and indirect, be recovered so that the foreign military sales program is not subsidized by Defense appropriations. The act requires that articles sold from Defense inventories to foreign governments be priced at either

- actual value, when the article is not intended to be replaced in the Defense inventory, or
- replacement cost, when the article is intended to be replaced.

Defense provides for the recovery of replacement cost through Department of Defense Manual 7290.3-M, which governs the pricing

of Defense articles sold to foreign countries. The manual directs that nonexcess materiel will be sold to foreign customers at the established standard price plus the current year's procurement account inflation rate. The sales price is to be established to ensure recoupment of the moneys necessary to procure replacement items.

RECOMMENDATIONS IN PRIOR GAO REPORTS

We have issued several reports in past years concerning pricing problems in the foreign military sales program. The following are recommendations applicable to secondary item pricing which we identified in prior reports.

Inadequate method is used to estimate replacement costs

In August 1978, we reported that Defense pricing policies for secondary item sales were inadequate to ensure that replacement cost was recovered because inflation factors were not accumulated. Failure to accumulate inflation charges would result in items being priced at less than replacement cost when the items had been purchased prior to the year in which they were sold.

For example, assuming an average annual inflation rate of 7 percent, an item last purchased in 1975, sold in 1979, and replaced in 1979 would cost about 31 percent more to replace than the standard 1979 price. However, under the Defense policy, the price charged the foreign customer would be only 7 percent higher than the 1975 procurement cost, an amount equivalent to the standard price plus 1 year's inflation.

We recommended that the Secretary of Defense revise the method for determining and charging replacement cost for items sold to foreign governments from Defense inventories. When items were purchased in years previous to the sale, compounded inflation factors should be used. To evaluate the adequacy of the prices charged foreign customers, we recommended that the Secretary of Defense assign specific responsibility for administering pricing policy and monitoring pricing systems to a new organization or to some existing organization that could be sufficiently freed from other work to provide careful surveillance over the pricing function.

Foreign customers do not share normal inventory losses

In September 1977, in August 1978, and again in May 1979, we reported that Defense appropriations were being used to subsidize the foreign military sales program because customers were not assessed a fair share of normal inventory losses. As a result, Defense was losing millions of dollars on sales to foreign governments.

Inventory losses are a normal cost of operating the Defense inventory system and include such elements of cost as losses on disposal of excess or obsolete equipment caused by technological improvements or errors in estimating needed quantities, damage and deterioration due to normal wearout, shortages discovered in physical inventories, and pilferage.

We recommended that the Secretary of Defense require the inclusion of normal inventory losses in charges to foreign governments for all nonstock fund items sold from Defense inventories. The Arms Export Control Act was amended in September 1978 to expressly require the recovery of these costs for items sold under supply support arrangements. Defense contended that foreign customers should not be charged for inventory losses on items not sold under supply support arrangements because Defense instructions prohibit sales unless the inventory level is above the reorder point. If these instructions were followed, Defense further contended, the foreign customer would not be participating in or benefiting from the Defense inventory system. We did not agree with the Defense position.

OBJECTIVES, SCOPE, AND METHODOLOGY

The overall objectives of our review were to determine whether our recommendations had been adopted and to assess any improvements in Defense's pricing policies and procedures. Specifically, we analyzed prices charged foreign military customers to determine whether the billing generated enough revenue to replace the items in Defense inventories and whether these customers were being assessed a fair share of indirect costs.

We were guided by a request from Senators Percy and Hollings that we evaluate Defense actions to improve financial management of the foreign military sales program. This request covered several areas including the actions taken by Defense to recover both replacement costs of secondary items and normal inventory loss costs when items were sold from inventory.

We examined applicable Department of Defense and military service regulations, accounting procedures and reports, computer printouts, and other documents relating to pricing of secondary items under the foreign military sales program, and discussed the program with responsible officials. We reviewed the legislative history of the Arms Export Control Act of 1976 and amendments thereto, and reviewed and analyzed related Defense and military service instructions and regulations governing the foreign military sales program. We visited four service locations, interviewed management personnel at each to identify policies and procedures for determining prices charged on foreign sales, and gathered data to assist in evaluating the adequacy of pricing policies and procedures.

To determine whether prices charged foreign customers were adequate to replace items in Defense inventories, we randomly selected a sample of fiscal 1979 transactions at each of the four inventory control points. The sample sizes selected were sufficient to provide a 95-percent confidence level in statistically projecting our results. The control points we visited, the number of transactions selected, and the universe of transactions follow.

<u>Inventory control point</u>	<u>Number of transactions randomly selected</u>	<u>Universe of transactions</u>
Army Missile Command Huntsville, Alabama	187	5,408
Army Tank-Automotive Command Warren, Michigan	65	740
Navy Aviation Supply Office Philadelphia, Pennsylvania	103	1,410
Air Force Air Logistics Center San Antonio, Texas	<u>45</u>	<u>1,510</u>
Total	<u>400</u>	<u>9,068</u>

Total estimated sales at these locations were \$68 million, representing about 81 percent of the total fiscal 1979 Defense estimated sales of \$84 million. We chose these locations in part because in addition to the high value of their secondary item sales, each used a different method for estimating replacement cost for billing purposes.

We discussed pricing policies and procedures with officials in the Office of the Assistant Secretary of Defense (Comptroller), Army Materiel Development and Readiness Command, and Naval Supply Systems Command, Washington, D.C.; Air Force Logistics Command, Dayton, Ohio; and the Security Assistance Accounting Center, Denver, Colorado.

We chose fiscal 1979 sales transactions to increase the likelihood that any procurements made to replace the items sold would have been accomplished. For those items that had not been replaced at the time of our review, we tried to determine whether Defense intended to replace the items. If replacement was not intended, the cost used in our comparisons was the actual cost of the item sold.

Because of the limitations in the scope of our coverage, we did not attempt to project specific dollar findings in this report to sales transactions at other Defense locations. We believe, however, that pricing practices similar to those observed at the four locations included in our review may exist at other Defense

locations not included in our review because all activities operate under standard pricing guidelines issued by Defense and use similar accounting and financial management systems.

The financial information in this report is based mainly on Department of Defense accounting records and information provided by Defense officials. The information could not be verified in the short time available for preparing this report, since the accounting systems involved are highly complex and the foreign military sales financial data is voluminous, involving thousands of individual cases.

CHAPTER 2

ITEMS ARE SOLD TO FOREIGN CUSTOMERS

AT LESS THAN REPLACEMENT COST

Incurring losses on sales of secondary items from Defense inventories is a longstanding problem. We reported in 1978 that large amounts were being lost by Defense because items were sold for less than replacement cost. Also, Defense's failure to recover normal inventory losses was discussed in three of our previous reports. To help ensure that pricing will improve in the future, Defense has begun to establish a special unit which will conduct pricing reviews. However, the problems noted in our previous reports continue to exist.

We estimate that in fiscal 1979 the Department of Defense subsidized foreign military sales by over \$8 million at the four locations included in our review because prices charged for sales of secondary items from Defense stocks were not adequate to replace those items in inventories. Prices were too low primarily because compounded inflation factors either were not applied or the rates of inflation used were not realistic.

Additional subsidies occurred because Defense did not charge a fair share of normal inventory losses on secondary item sales. We estimate that for just the four locations visited, about \$3.3 million would have been recovered through the application of a normal inventory loss factor to the prices charged for secondary items.

REPLACEMENT COSTS ARE NOT RECOVERED

Our review showed that the prices billed were not sufficient to replace the items in inventory. We attribute this condition to both the method prescribed by Defense to estimate replacement cost and to the inflation rates used to formulate the estimate.

When foreign requisitions are filled from Defense inventories, the sales prices are determined and billings are made at time of shipment. The cost to replace those items in inventory cannot be known with any degree of certainty at the time billings are made. To avoid the time consuming and error prone process of subsequently revising the billings after items have been replaced, the customers are charged "estimated" replacement cost. The use of estimates is permissible under the Arms Export Control Act.

It is unlikely that any estimating method could exactly forecast actual replacement cost. To comply with the intent of the act that Defense appropriations not be used to subsidize the foreign military sales program, however, it is important that Defense use an estimating procedure that forecasts actual replacement cost as closely as possible.

Department of Defense Manual 7290.3-M prescribes the method to be used in estimating replacement costs. The manual states that by definition all nonexcess secondary items sold from Defense inventories will be replaced; it directs Defense elements to estimate replacement costs by adding a single year's inflation rate to the standard inventory prices of these items. Defense officials concede that this procedure will underprice some transactions, such as those for items purchased 2 or 3 years prior to the sale, and is likely to overprice other transactions, such as those for items recently purchased. They believe, however, that if this procedure were uniformly applied, it would generate enough revenue to pay for those items that are eventually replaced.

Inflation rates should be compounded

We found that Defense was in error in assuming that its estimating procedure was adequate to recover replacement cost. Further, the inflation rates prescribed by Defense were unrealistically low. At the four inventory control points we visited, we randomly selected 400 foreign military sales requisitions for secondary items. Based on our sample results, we estimate that replacement costs exceeded amounts charged foreign customers by about \$8 million. ^{1/} This amount would have been even greater if the Army Missile Command had not adopted procedures that provide a better approximation of replacement costs. The Army Missile Command uses an automated pricing procedure that first determines if an item is expected to be replaced within 5 years. If so, the sales price includes estimated inflation from the time the item was last purchased through the anticipated replacement period.

For comparison purposes, we recomputed the billing prices for the 400 requisitions in our random sample using the Army Missile Command pricing method rather than the method prescribed by Defense policy. Although the billing prices for some items exceeded replacement cost under each of those methods, the overall billing prices did not recover replacement cost on a total basis under either method. We found that the command's method resulted in a .93 ratio of billing price to replacement cost, whereas Defense's method resulted in a .87 ratio. We also found that the losses experienced at the four locations would have been about \$2.8 million, or 30 percent lower, using the compounding procedure than they were using Defense's method. There is no doubt that the command's method yields closer approximations of replacement costs. The need for Defense to compound inflation rates is illustrated by the following example.

The Army purchased frequency converters in August 1977 at a price of \$3,314. In February 1979, the Army sold two of the items

^{1/}Statistical analysis based on a 95-percent confidence level with an error range of \pm \$5.6 million.

to foreign customers for \$3,539 each (\$3,314 plus a single year's inflation rate: the fiscal 1979 inflation factor of 6.8 percent). Eight months later the replacement price of the item was \$6,899. Thus, the Army underbilled by \$3,360 per item. Although the usage of compounded inflation factors as we recommended would not have recovered the full replacement cost in this instance, it would have reduced the amount of loss on the sale.

The need for Defense to change its estimating procedures was confirmed in a study (app. II), conducted by two Air Force officers attending the Air Force Institute of Technology. Preliminary results of this study show that by not recognizing prior years' inflation, current Defense procedures will not provide for recovery of replacement costs of secondary items sold from inventory. Based on a sample of requisitions filled in the first quarter of fiscal 1981, the officers estimated that the Air Force would lose from \$7.2 million to \$44.4 million annually using the Department of Defense method of estimating replacement costs. Of the 512 requisitions analyzed in that study, replacement costs exceeded billing prices 88 percent of the time.

In our August 1978 report, we pointed out that many millions of dollars were lost to the Government because of Defense's failure to recover replacement costs for items sold to foreign governments from inventory. We recommended that an estimating procedure similar to the one used by the Army Missile Command be adopted for Defense-wide application. Defense officials did not concur in our recommendation because of their belief that although their estimating procedures will underprice some items, such as those for equipment purchased 2 or 3 years prior to the foreign sale, the procedure is also likely to overprice items more recently purchased.

Although we agree that the Defense estimating procedures do result in overpricing of some items, our work shows that far more underpricing than overpricing occurs under these procedures. Therefore, we believe our recommendation that Defense approximate replacement cost by using compounded inflation factors is still the most effective and least costly way of recouping replacement cost on a total basis.

More realistic inflation factors are needed

In addition to changing its estimating procedures, Defense needs to prescribe more realistic inflation rates. Our analysis showed that revising the method of estimating replacement cost would not provide enough revenue to recover replacement costs when the inflation rates prescribed by the Department of Defense are used. The rates used are those provided by the Office of Management and Budget for preparation of the President's budget. Historically, these rates have been shown to be a conservative forecast of price changes. A Defense official told us that these official rates have proved to be too conservative in 10 of the last 11 years.

In a recent study by the Air Force Logistics Command of 150 secondary items, an average cost increase of 23 percent in fiscal 1980 was disclosed. These items were budgeted at an inflation rate of only 7 percent. Also, the Pratt and Whitney Aircraft Company, a major supplier of secondary items for the Air Force, recently advised the Air Force Logistics Command that secondary item prices in fiscal 1981 would be 25 to 30 percent higher than in fiscal 1980. The current procurement account inflation rate for fiscal 1981 is 9.7 percent.

While there may be valid reasons for making conservative assumptions in predicting a low rate of inflation for budgetary purposes, we believe it is counterproductive to use conservative inflation rates when pricing goods sold to foreign governments.

ALL NORMAL INVENTORY LOSSES ARE NOT
REQUIRED TO BE RECOVERED

Additional subsidies to the foreign military sales program occur because prices of items sold under other than cooperative logistics supply support arrangements do not include an equitable share of normal inventory losses. Assuming that these secondary item sales have not decreased since 1979 (data on more current sales were not readily available), we estimate that this subsidy will amount to about \$3.3 million during fiscal 1981 at the four locations included in our review.

Inventory losses are a normal cost of operating the Defense inventory system. Included are such costs as disposal of excess or obsolete items, damage and deterioration, inventory shortages and overages, and pilferage.

One equitable way of allocating inventory losses is to determine their relationship to total inventory values and then, using this ratio, prorate the cost to sales. This is the logic we used in our estimate of the abovementioned \$3.3 million loss. The fiscal 1980 costs incurred at the four locations included in our review and their relationship to total inventory values are shown in the following chart.

<u>Category</u>	<u>Army Missile Command</u>	<u>Army Tank- Automotive Command</u>	<u>Navy Aviation Supply Office</u>	<u>Air Force Air Logistics Center</u>
	<u>----- (thousands) -----</u>			
Disposal of excess or obsolete items	(\$16,063)	(\$29,492)	(\$316,451)	(\$67,201)
Damage and deterior- ation	(a)	(a)	(a)	(44,768)
Inventory shortage and overage	7,110	(1,238)	17,310	(3,907)
Pilferage	<u>-</u>	<u>-</u>	<u>(b)</u>	<u>-</u>
Total (losses)	(\$ <u>8,953</u>)	(\$ <u>30,730</u>)	(\$ <u>299,141</u>)	(\$ <u>115,876</u>)
Total inventory value	<u>\$426,012</u>	<u>\$477,957</u>	<u>\$4,403,080</u>	<u>\$1,613,324</u>
Losses as percent of inventory value	2	6	7	7

a/ Applicable amounts are included in the disposal category.

b/ Amounts, if any, are included in the shortage and overage category.

In three previous reports (see p. 3) we disclosed that the United States was losing millions of dollars on sales to foreign governments because normal inventory losses were not being recorded.

In responding to one of our previous reports, the Department of Defense stated that inventory loss costs should not be assessed on secondary item sales to customers not covered by cooperative logistics supply support arrangements because these customers do not participate in or benefit from the inventory system. To make sure they do not benefit from the inventory system, Defense officials further stated, instructions require that secondary item requisitions from these customers not be filled unless inventory levels are above reorder points. When the inventory levels are below reorder points, the requisitions are to be backordered until stocks again exceed reorder points. Thus the cost of inventory losses would not be borne by customers not a party to support arrangements.

Our review showed that, contrary to Defense instructions, secondary item requisitions were frequently filled when inventories

were below the reorder point. At one of the inventory control points, for example, 85 percent of the sampled transactions were filled when the total inventory was below the reorder point. At another inventory control point, 71 percent of the sampled requisitions were filled when inventories were below the reorder point. An Air Force official told us that "real world politics" dictate that the Air Force sometimes fill these requisitions when inventories are below the reorder point. For example, if a foreign ally had an F-16 aircraft grounded, awaiting a repair part with a procurement leadtime of 2 years, it is highly unlikely that the Air Force would permit the customer's aircraft to remain grounded for that period of time even though the inventory level was below the reorder point.

Since most requisitions were filled when inventories were below the reorder points, there can be little doubt that those governments not participating in a cooperative logistics supply support arrangement also benefit from Defense's inventory system. Accordingly, they should share in the costs of operating this system. Allocating indirect costs such as inventory losses to all customers benefiting from the system that generated those costs is not only equitable but a standard accounting practice.

We also noted that the Department of Defense prorates inventory loss costs of all sales from the stock fund whether or not the sales are under cooperative arrangements. According to Defense officials, since the stock fund is intended to be self-sustaining, it must recover normal inventory losses from its customers or its capital will continually shrink. On the other hand, money to buy secondary items comes directly from appropriations. We do not understand this inconsistency. In our opinion, the fact that funds can be appropriated to cover the losses is inadequate justification for not allocating a portion of the losses to foreign customers.

In passing the Arms Export Control Act, the Congress intended that all indirect as well as direct costs be recovered so that the foreign military sales program would not be subsidized by Defense appropriations. Normal inventory losses--those caused by obsolescence, damage, deterioration, and pilferage--are indirect costs. However, the act, as amended in 1978, requires only that foreign governments be charged for normal inventory losses on sales "from stock of Defense articles that are being stored at the expense of the purchaser of such articles" (underscore added).

Only foreign governments that are parties to support arrangements bear expenses for storage and Defense procedures require that only those governments with such arrangements be charged for normal inventory losses on sales of secondary items. To help ensure that all foreign governments who benefit from Defense's inventory system are charged an equitable share of normal inventory losses, the Congress should amend the Arms Export Control Act to require such charges on all sales from Defense inventories.

ESTABLISHMENT OF QUALITY ASSURANCE PRICING PROGRAM HAS BEEN INITIATED

Defense has initiated action to establish quality assurance controls over its pricing of foreign military sales. The persistence of pricing problems over several years prompted the recommendation in our August 1978 report that a Defense organization be given specific responsibility for ensuring effective and consistent implementation of foreign military sales pricing policies. Although this responsibility was assigned to the Security Assistance Accounting Center in September 1978, the function is still not fully staffed.

Security Assistance Accounting Center officials, in planning to implement the quality assurance program, estimated that 14 positions would be necessary but only 4 were subsequently approved. It was not until March 1981 that the Center received a total of 12 personnel space authorizations. A Defense official attributed the delay to a personnel shortage.

The quality assurance program, if implemented properly, can help ensure that the foreign military sales program is not subsidized by Defense appropriations.

OPPORTUNITY EXISTS TO RECOVER UNDERBILLINGS

In recovering costs of foreign sales up to and including final billing, the Department of Defense standard sales contract provides that adjustments may be made to estimated costs that are not commensurate with actual costs. Therefore, any costs that have not been recovered by the military services on those sales contracts for which final billing has not been made could and should be billed. As to undercharges that may be found after final billing, Department of Defense Manual 7290.3-M provides that adjustment to final billings are permitted when there are unauthorized deviations from Defense pricing policies.

CONCLUSIONS

Defense pricing policies and practices for foreign military sales of secondary items still do not recover estimated replacement costs as required by law. Many millions of dollars continue to be lost and Defense appropriations continue to subsidize the foreign military sales program. To comply with the statutory requirement and the intent of the Congress that Defense not subsidize foreign military sales, Defense must take action to correct the weaknesses in its pricing policies and practices.

Defense should also make a reasonable attempt to collect from foreign customers undercharges that resulted from failure to charge a closer approximation of replacement cost as required by law.

The longer Defense takes to attempt to collect undercharges, the more difficult it will be to recover these amounts from foreign governments. Action should be taken to collect undercharges as expeditiously as possible before the military services make final billings for contracts on which the undercharges occurred. Also, final billings should be adjusted when unauthorized deviations from Defense pricing policies are discovered.

RECOMMENDATION TO THE CONGRESS

To ensure that all foreign governments are treated equitably and all indirect costs are properly charged, we recommend that the Congress amend the Arms Export Control Act to require that all sales from Defense inventories reflect the cost of normal inventory losses. (Suggested legislative language is attached as app. III.)

RECOMMENDATIONS TO THE SECRETARY OF DEFENSE

To help ensure equitable and effective pricing of secondary items and avoid subsidies to foreign customers, we recommend that the Secretary of Defense:

- Instruct Defense components to use compound inflation factors when estimating replacement cost.
- Prescribe a more realistic inflation index.
- Use the quality assurance unit recently established at the Security Assistance Accounting Center to ensure that Defense components adequately and uniformly implement the revised estimation procedures.
- Direct the military services to make every reasonable effort to recover from foreign governments the past undercharges in sales of secondary items.

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United States Senate

COMMITTEE ON
 GOVERNMENTAL AFFAIRS
 WASHINGTON, D.C. 20510

May 27, 1980

The Honorable Elmer B. Staats
 Comptroller General
 of the United States
 Washington, D.C. 20548

Dear Elmer:

During the past several years, the General Accounting Office has issued a number of reports on the accounting and financial management of the Foreign Military Sales Program by the Department of Defense. These reports have resulted in budget reductions in the past and indicate that a potential exists for further budget reductions in the future.

As several of the recommendations have not been implemented, the Defense appropriations are apparently being used to subsidize the Foreign Military Sales Program. This has been a continuing problem within Defense and it appears that Defense needs to devote additional attention to this area to bring about budget reductions.

In this regard, we would appreciate your staff reviewing recent actions by Defense to implement the recommendations in your reports and other actions taken by Defense to improve its management of the program. We would appreciate your office developing questions for use by the Committee during hearings on the fiscal 1982 Defense budget. In addition, we would appreciate a detailed report on this matter by June 30, 1981.

Senator Percy's staff has discussed this review with members of your Financial and General Management and Studies Division, Systems in Operation group.

Sincerely,


 Charles H. Percy
 United States Senator


 Ernest F. Hollings
 United States Senator

aib



DEPARTMENT OF THE AIR FORCE
HEADQUARTERS AIR FORCE LOGISTICS COMMAND
WRIGHT-PATTERSON AIR FORCE BASE OHIO 45433

10 JUN 1991

CV

PRICING OF AIR FORCE INVESTMENT ITEMS

HQ USAF/AC/LE

1. The attached AFIT Thesis was recently completed under the sponsorship of this Headquarters. This thesis clearly shows that the OASD(C) pricing policy for the sale of nonprogrammed investment items from inventory to FMS does not allow us to recoup the estimated replacement price. The thesis research found that the Air Force, on an average, is losing between \$231.43 and \$553.15 for every nonprogrammed item sold from its inventory. This would equate to an annual loss (or subsidization) of between \$7.2 million and \$44.4 million.

2. It is requested that the data contained in this thesis be used to persuade OASD(C) to change or waive the pricing guidance in DODI 2140.1, Pricing of Sales of Defense Articles and Defense Services to Foreign Countries and International Organizations. Specifically, the last sentence of paragraph VI.B3a should be deleted or waived to allow us to update the standard price to reflect prior year(s) inflation.

3. The thesis does not settle the contention raised in the past that the pricing policy in DODI 2140.1 is correct if we never satisfy a nonprogrammed requirement from on-hand stock unless we are above the control level. We should back order the item until sufficient stocks are available or place the item on contract for direct shipment. However, the real world will not let us operate in this fashion. We frequently are in the position where we can ship below the control level without jeopardizing either Air Force or programmed FMS support. Use of the control level is also often complicated by direction from higher headquarters to ship nonprogrammed items to a high priority FMS customer (e.g., The Egyptian Peace Pharaoh Program) or for us to satisfy FMS high priority nonprogrammed orders. We cannot let an FMS aircraft sit on the ground for the procurement lead time when we have sufficient stock available below the control level. The necessary control is that the decision to ship below the control level is made by the Item Manager on a case-by-case basis as required by AFM 67-1, Volume IX, Paragraph 7-73a.(2). Support below the control level should be based on logistical rather than financial considerations.

4. While the AFIT Thesis only addresses FMS sales, its findings also apply to the Air Force. Examples are:

a. Use of outdated standard prices would result in an understatement of the Air Force spares dollar requirements used in budget estimates and POMs if we did not do a manual off-line computation. Mechanized updates would eliminate a substantial portion of the manual adjustments for budgetary purposes and thus increase the credibility of the budgetary documents.

AFCC - Policies of the Procurement Team

b. When Purchase Requests are submitted for procurement at the current standard price, many of them must be returned for additional funding prior to contract award. This creates additional administrative lead time.

c. Repair versus reprourement decisions are largely based on the repair cost as a percentage of reprourement price. Generally speaking, if the repair cost exceeds 75 percent of the reprourement price, we reprocure. Again, we must make a manual off-line computation to insure that we are using a realistic reprourement price.

d. The lack of a realistic standard price also affects us in dealings with other DOD customers, e.g., Army and Navy. If we sell them an item to satisfy an immediate requirement, we must make up the difference between the current standard price and the reprourement price with Air Force resources. Sales to other than the FMS program account for about 20 percent of the total reimbursable collections in the three procurement appropriations for FY 1980.

5. We have a Data Automation Requirement (DAR) prepared which will automatically update the current standard price for investment items with the current year OSD prescribed inflation factor if the item has not been reprocured within the previous twelve months. A new representative procurement price would override the estimate and start the twelve month cycle again. We will have to build in controls for exceptional situations, such as, very old items for which no possibility of reprourement exists or items which include precious metals. We feel that implementation of this DAR will solve many of our internal Air Force problems in this area. We, therefore, request action be taken to obtain a change or waiver to DODI 7200.7, Accounting and Pricing for Material Financed by Procurement Appropriations for Military Functions to allow us to implement this DAR independent of the OASD(C) action on the FMS pricing problem. Should the FMS pricing policy not change, we will have to modify this DAR to exclude FMS transactions.

6. We would appreciate you keeping us informed on your progress in this matter.


RICHARD E. MERKLING
Lt General, USAF
Vice Commander

1 Atch
AFIT Thesis LSSR 6-81, June 1981, A
Statistical Analysis of Recovering Re-
placement Costs of Foreign Military Sales
Items Sold from Air Force Inventories

SUGGESTED AMENDMENT TO THE
ARMS EXPORT CONTROL ACT

To implement our recommendation, Section 21(e)(1)(D) of the Arms Export Control Act should be amended to read as follows:

"(D) the recovery of ordinary inventory losses associated with the sale from stock of defense articles."

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